

JOIN THE CROWD?

THE PERKS AND POTENTIAL PITFALLS OF CROWDSOURCING

by Phil Josephson

"Any change, even a change for the better, is always accompanied by drawbacks and discomforts."

- Arnold Bennett

Crowdsource funding is a hot topic these days with positive commentary about the benefits of the JOBS Act as it relates to small companies raising capital. The Crowdfunder exemption to the JOBS Act does allow for new areas of capital for a small business, but there are costs and downsides to the small business.

To date, if a company wants to raise money, it often does so through a private offering. This private offering is (hopefully) constructed in compliance with State and Federal Securities laws and is made pursuant to an exemption to those laws, regulations and requirements. In this compliance, the company must adhere to guidelines, which notably include the prohibition to make the private offering in a general solicitation. This requirement limits the universe of potential investors that the company may access.

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups (JOBS) Act, a series of legislative provisions intended to facilitate capital formation in the United States. Part of this legislation includes the Entrepreneur Access to Capital Act, otherwise referred to as the crowdfunder (crowdfunder) exemption. The crowdfunder exemption makes significant changes in current Federal and State Securities laws.

The crowdfunder exemption will allow entrepreneurs to raise capital by offering to sell interests in their business over the Internet. Under the crowdfunder exemption, a small business will be allowed to raise \$1 million in a 12-month period by selling its securities to investors without registering that offering with Federal

or State Securities regulators. The exemption, however, places limitations on how and to whom a small business can sell its securities.

The newfound ability for small businesses to seek investment capital will allow companies to use an intermediary to facilitate the marketing of the private offering and the collection of the investment capital. The intermediary will be a broker-dealer or a funding portal Web site (platform). Crowdfunder funding platforms such as Kickstarter and IndieGoGo are successful in connecting small businesses that need money with investors that want to invest in small businesses.

Currently, non-broker-dealer platforms may only raise monetary investments in exchange for a product or service made or provided by the company. In the current environment, securities may not be offered or sold, however, the Act directs the Securities and Exchange Commission to adopt rules within 270 days to implement a new exemption to allow securities sales through crowdfunder funding. Therefore, time will tell how the SEC will change the structure.

Whether a company provides merchandise to the investors or provides securities to the investors, crowdfunder funding has its perils. The primary deterrent to crowdfunder funding a small business should contemplate is the hundreds of stakeholders a company may have as a result of successful use of crowdfunder funding to raise capital. With every investor comes a possibility of distraction or nuisance to the small business. At any time, the people who have invested even a nominal sum in the business will have all rights and privileges afforded to a shareholder. Another detriment to crowdfunder funding is the need to comply with the remainder of the Securities laws, rules and regulations.

The crowdfunder exemption is only one exemption from Securities laws registration requirements. The small business must continue to be knowledgeable of, and comply with, Federal and State Securities laws, especially regarding disclosure requirements. In addition, the small business must be mindful of who it works with as it pursues crowdfunder funding. This new access to capital will have the possibility of unscrupulous "players" taking advantage of the small business in the way of egregious fees, incorrect advice and exposure to Securities laws violations.

The crowdfunder exemption of the JOBS Act is an exciting alteration to the arcane Securities laws, especially for entrepreneurs and small businesses. There is much to learn and understand as we collectively await the SEC's rules for crowdfunder funding. For small businesses that may contemplate a private offering in reliance on the crowdfunder funding exemption, do so cautiously, and seek guidance before you begin the process. The crowdfunder exemption may be a good change, but it may not be right for every business. 

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